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STATE FOR EUR/RUS, EEB/IFD
TREASURY FOR BAKER/TORGERSON

E.O. 12958: N/A
TAGS: EFIN ECON RS
SUBJECT: SUBPRIME MORTGAGE CRISIS NOT AFFECTING RUSSIAN BANKS - SO FAR

¶1. This message is sensitive but unclassified and not for Internet distribution.

Summary

¶2. (SBU) The largest potential threat that the U.S. subprime mortgage-induced liquidity squeeze poses for Russian banks is higher borrowing costs, according to Moscow-based private banks. In recent years, Russian banks have relied on internationally-sourced credit financing to provide as much as 40 percent of the funds that they loan to their clients. The higher interest rates Russian banks face in the current environment would need to be passed along to the banks' clients. These corporate and retail clients, however, would probably be reluctant to take on costlier loans, which, in turn, would also be passed along in the form of higher consumer prices, spurring inflation. In an effort to remain competitive, many Moscow-based banks have opted not to initiate this potential chain reaction by postponing Eurobond issuances they had planned for fall ¶2007. End Summary.

Financial Intermediation in Russia

¶3. (SBU) Russia has been somewhat insulated from the ripple effect of the subprime liquidity squeeze because of the lingering effects of the comparatively low level of financial intermediation that Russian banks provide, according to Alfa Bank Senior Economist Natalya Orlova. The relative lack of financial intermediation in Russia has been a function of two critical factors. First, for years Russians mistrusted banks. This meant keeping savings in hard currency rather than bank deposits. Consequently, banks could not pool savings and turn them into loans for would-be borrowers. Second, many of the country's largest private banks previously existed to meet the financing needs of the corporations that created them. This "favored relationship" with their large parent corporations afforded banks the luxury of providing loans and services to low-risk, related parties.

¶4. (SBU) Orlova said however, that improved economic conditions, a stronger ruble and higher incomes in combination with the national deposit insurance program have boosted confidence as well as the volume of retail deposits in the country's banks. Consequently, banks have been amending their operating strategies in the last three years to diversify their client base away from the "low-hanging fruit" by increasing their consumer credit, mortgage lending, and small business services. This strategy recalibration has been a priority for banks as they worked to improve their international ratings, a must for accessing intermediate-term credit financing, which until recently had been readily available and

relatively cheap outside Russia.

Subprime Effect on Russian Banks

¶5. (SBU) Representatives of Moscow-based private banks, which account for half of Russia's licensed banks, explained to us that their central concern about the subprime situation is the threat of higher borrowing costs. This concern has disrupted many banks' plans to issue Eurobonds this fall.

¶6. (SBU) Moscow Credit Bank's Deputy Chairman of the Board Andrey Ivanov noted that the current emerging market revaluation had made the cost of issuing Eurobonds too high. As a result, Moscow Credit Bank has postponed indefinitely the Eurobond issuance it had planned for September 2007. Ivanov explained that the bank had determined its clients would not take on additional debt at this time if doing so meant borrowing at a higher cost, which would then be passed along in the form of higher prices.

¶7. (SBU) BIN Bank Vice President Irina Komarova echoed Ivanov's assessment, adding that her bank could not afford to pass along these inflationary costs to clients. She said that syndicated loans, however, have become only marginally more expensive than they were before the subprime issue and would probably serve as a feasible substitute until the subprime dust settled.

Banks Hope Subprime Just Bump in the Road

¶8. (SBU) The low risk of most loan portfolios has helped insulate Russian banks from the immediate effects of the subprime issue, according to PromSvyazBank's Financial Institutions Unit Director Marina Kareeva. Russian banks have sustained high growth rates by capturing their parent corporations' and related parties' business with little competition. MDM Bank's Managing Director for International Funding Tengiz Kaladze said that, because of banks' rather privileged position, "they never moved down the risk chain to finance subprime borrowers or create a massive junk bond market."

¶9. (SBU) BIN Bank's Komarova said that banks, however, are becoming more competitive, expanding their mortgage and small business lending businesses. She characterized this nascent client diversification as a matter of survival, emphasizing that expanded retail operations, especially in the regions outside Moscow and St. Petersburg will be "where the growth is." Komarova said, however, that banks have been slow to respond to the rising demand for credit that Russia's improving economic conditions have fostered.

¶10. (SBU) Revaluations of emerging market risk have, however, created fluctuations on Russian exchanges and prompted a liquidation of some USD 7.6 billion in August, which was below the GOR's forecast of USD 10 billion for the month. Although a measure of calm appears to be returning-Russian mutual funds logged USD 125 million of net inflows during August, compared to USD 47 million in net outflows during July-many Moscow-based banks are hoping that pre-subprime interest rates will again be available to them by early ¶2008.

Comment

¶11. (SBU) The uncertainty resulting from the subprime situation has, for the moment, struck only a glancing blow to Russia's banking sector. Loan portfolios have generally not been affected; banks are still able to service their debt; and non-performing loans have not spiked. That said, if the sub-prime crisis drags on for any length of time, it could eventually have a greater impact and lead to tighter credit and higher interest rates, which in turn could affect growth projections.

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